(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business * * *"

Section 212—"Expenses for Production of Income. "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the maagement, conservation, or maintenance of property held for the production of income * * *"

Section 1234(a)—"Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if if acquired by him)."

Section 7805(b)—"Retroactivity of Regulations or Rulings.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

Statement of the Case

The petitioners are husband and wife who filed joint income tax returns for the calendar years 1952, 1953 and 1954 on the cash basis with the District Director of Internal Revenue at Scranton, Pennsylvania. Alice R. Gerstell is a petitioner herein solely because of the filing of such joint returns, and Robert S. Gerstell will hereinafter be referred to as the "petitioner".

In the latter part of 1952, an insurance agent, Mr. Norman E. Ritter, suggested to the petitioner that the latter purchase certain annuity contracts. Through Mr. Ritter, in December 1952, the petitioner purchased three annuity contracts from the Republic National Life Insurance Company (hereinafter the "insurance company"), each providing for monthly annuity payments of $2,013.82 beginning December 1993, to be made, respectively to the petitioner's son, Arnold F. Gerstell, and to his daughters, Mary A. Gerstell and Roberta Gerstell. In each of the three annuity policies, it was provided that during the lifetime of the petitioner all rights of every kind were reserved to the petitioner and could be exercised by the petitioner without the consent of the annuitant, and that upon the death of the petitioner said rights were to vest in his estate.

During the calendar year 1952, the petitioner incurred, in the following manner, out-of-pocket expenditures from his own funds aggregating $44,920.83 in connection with the annuity contracts: On December 23, 1952 the petitioner issued a check in the amount of $20,000 to the insurance company in payment of the first annual premiums on the three annuity policies. The insurance company acknowledged receipt of these premium payments on December 31, 1952. On December 30, 1952, the petitioner obtained from The Philadelphia National Bank the total amount of $473,710, giving three personal notes therefor and pledging as collateral security for each note, one of the three annuity policies. Subsequently, on December 30, 1952, the petitioner paid to the insurance company the amount of $473,710 in full satisfaction of all the premiums to become due under the three annuity policies, by having The Philadelphia National Bank credit said amount to the insurance company's account with the bank. Under date

of December 28, 1952, the petitioner issued to the insurance company a check in the total amount of $84,994.84, for which the insurance company issued receipts designating the amount as "Interest due on loan" and indicating that interest was paid (on the loans hereafter described) to the respective anniversary dates of the annuity contracts in 1956. After the preceding payments to the insurance company, the petitioner owned three fully paid-up annuity contracts with "cash or loan" values aggregating $533,784.01 (computed as of the dates in 1956 to which interest had been prepaid). On December 30, 1952, the petitioner obtained the aggregate amount of $533,784.01 from the insurance company and executed agreements designated "Annuity Loan Agreements". On the same date, the petitioner paid to The Philadelphia National Bank the aggregate amount of $474,078.45 in full satisfaction of the notes previously referred to, including interest and clearance charges.

During the calendar year 1953, the petitioner incurred, in the following manner, out-of-pocket expenditures from his own funds aggregating $45,055.18 in connection with the annuity contracts: On December 23, 1953, the petitioner issued a check in the amount of $101,097.17 to the insurance company, for which the latter issued receipts designating the amount as "Loan—Interest due" and indicating that interest was paid to the respective anniversary dates of the contracts in 1960. After the payment of this amount, the "cash or loan" values of the annuity contracts increased from $533,784.01 to $589,826.00, or by $56,041.99. Shortly thereafter in December, 1953, the petitioner obtained the amount of $56,041.99 from the insurance company and executed agreements designated "Annuity Loan Agreements".

During the calendar year 1954, the petitioner incurred, in the following manner, out-of-pocket expenditures from his own funds aggregating $58,033.07 in connection with the annuity contracts. On December 22, 1954, the petitioner issued to the insurance company a check in the amount of $118,865.26. Thereafter the insurance company determined that this amount should have been $118,265.06 and issued a refund check to the petitioner in the amount of $600.20, which check was received by the petitioner on December 28, 1954. The insurance company issued a receipt for the correct amount of $118,265.06, designating said amount as "Loan-Interest due" and indicating that interest was paid to the respective anniversary dates of the contracts in 1964. After the payment of this amount, the "cash or loan" values of the annuity contracts increased from $589,826.00 to $651,057.99, or by $61,231.99. Shortly thereafter, in December 1954, the petitioner obtained from the insurance company the amount of $59,731.99 (an aggregate of $1,500 less than the "cash or loan" values of the annuity contracts) and executed agreements, each designated "Annuity Loan Agreement". In December 1954, the petitioner transferred the three annuity contracts, subject to the outstanding loans thereon in the aggregate amount of $649,557.99, to Moylan Investment Corporation (hereinafter "Moylan"). Moylan paid petitioner a total of $500 for the three annuity contracts by a check dated December 15, 1954.

Moylan is a Delaware corporation organized on October 9, 1953 and owned by Mr. Evan L. Synnestvedt, a general agent of the insurance company, and persons related to him. The petitioner is not related in any way to the officers and stockholders of Moylan, and never had any business transactions with them except with respect to

the annuity contracts. On December 23, 1954 Moylan executed new annuity loan agreements with the insurance company. On January 5, 1955, Moylan surrendered the three annuity contracts to the insurance company, and on January 6, 1955 received, in return, proceeds of $104,336.98. The amount of surrender value, unlike the amount of the loan value, had been computed as of the date of surrender, in 1955 and prepaid interest had been returned. The petitioner did not learn that the contracts had been surrendered by Moylan for so large a sum until about a week before the hearing of this case by the Tax Court on October 30, 1961. At the time that the petitioner was contemplating the sale of the annuity contracts to Moylan, the insurance agent, Mr. Ritter, had advised the petitioner that their surrender value was infinitesimal.

The aggregate out-of-pocket expenditures of the petitioner for the three years in issue in the present case may be summarized as follows:

	1952	1953	1954	Totals
Aggregate premiums paid on annuity contracts	$493,710.00	$ —	$ —	$493,710.00
Aggregate interest paid on annuity loans	$ 84,994.84	$101,097.17	$118,265.06	$304,357.07
Total payments	$578,704.84	$101,097.17	$118,265.06	$798,067.07
Less:				
Aggregate annuity contract loans received	$533,784.01	$ 56,041.99	$ 59,731.99	$649,557.99
Payment received upon sale of annuity contracts	—	—	500.00	500.00
Total receipts	$533,784.01	$ 56,041.99	$ 60,231.99	$650,057.99
Net out-of-pocket expenditures	$ 44,920.83	$ 45,055.18	$ 58,033.07	$148,009.08

In entering into the transactions described above, the petitioner relied on the administrative position of the respondent as set forth in seven letter rulings issued by the respondent to various taxpayers and shown to the petitioner by Mr. Ritter. These letter rulings were issued in the years 1947, 1948, 1950, 1951 and 1952; the earliest was dated October 16, 1947, and the latest, November 6, 1952. The rulings stated generally that interest paid on a loan secured by an annuity policy on which the premiums had been prepaid was deductible for income tax purposes. Most of them stated that a cash basis taxpayer would be permitted to deduct such interest payments to the insurance company which issued the policy provided that the interest was paid in cash. Most of them also stated that prepaid interest would be deductible by a cash basis taxpayer in the year of payment. Several stated that the increase of the loans from time to time to the maximum loan values of the annuity contracts would not affect the tax consequences. One ruling stated that if such an annuity contract were sold, other than to the issuing insurance company, at a price in excess of the cost basis, the gain would be taxable as a capital gain. Two of the letter rulings, one relating to a bank and the other to the issuing insurance company as the lender, were issued to Evan L. Synnestvedt, the insurance broker through whom the petitioner ultimately bought the annuity contracts. One of the rulings, relating to the issuing insurance company as the lender, was issued to D. E. Williams, who had a business in the petitioner's community.

The petitioner would not have entered into the transactions in question if he had not believed that interest paid on annuity contract loans was deductible for income

tax purposes. Furthermore, he was in a position to borrow the amounts necessary to finance the annuity contracts from a bank rather than from the insurance company. However, the respondent's position expressed in the ruling, upon which position the petitioner relied, was that there was no distinction to be made between a bank loan and an insurance company loan in this type of case. The petitioner's attorney expressed the opinion that the respondent would not retroactively reverse his views as set forth in the rulings.

On their joint federal income tax returns for the calendar years 1952, 1953 and 1954, the petitioners deducted from their gross income the respective amounts of $84,994.84, $101,097.17 and $118,865.26 as interest paid to the insurance company as previously set forth. The respondent, by his notices of deficiency, disallowed said deductions in their entirety. The Tax Court approved the disallowance of the amounts of interest paid, refused to allow the petitioner to deduct any of his out-of-pocket expenditures, and, accordingly, determined deficiencies in federal income taxes for the years 1952, 1953 and 1954 in the respective amounts of $57,449.10, $78,845.50 and $92,122.67. The United States Court of Appeals for the Third Circuit affirmed the decision of the Tax Court in its entirety.

Reasons for Granting the Writ

1. The decision of the United States Court of Appeals for the Third Circuit in the present case conflicts with decisions of the United States Courts of Appeals for the Second and Ninth Circuits.

The Third Circuit in the present case wrote no opinion but "affirmed on the comprehensive opinion of Judge Black [of the Tax Court]." Consequently, we must look to the latter opinion to determine the basis of the decision in this case. The underlying theory upon which the Tax Court relied in refusing to allow the petitioner to deduct the out-of-pocket expenses incurred by him is set forth in the following excerpt from the Tax Court's opinion:

> "In order to qualify under the loss sections of the 1939 and 1954 Codes it would be necessary to conclude that the transactions were entered into for profit, though not connected with a trade or business. We cannot reach this conclusion. An economic gain for the petitioners would only result if the interest payments were allowed as a deduction and if the income accrued on the annuities would be realized as capital gain on a sale prior to maturity. We do not believe that a transaction may be considered as a transaction entered into for profit if the only economic gain derived therefrom results from a tax reduction. This view has expressly been adopted by the Tax Court in *Eli D. Goodstein*, 30 T.C. 1178 (1958) and *Morris R. DeWoskin*, 35 T.C. 356 (1960)." 21 C.C.H. T.C.M at 997-998, 1962 P-H T.C.M. ¶62,181 at 1099 (1962).

The Tax Court's position, thus, is that no deduction is allowable where the economic gain expected arises from

the interplay of an ordinary deduction and a long-term capital gain or, in other words, is an after-tax gain. This position is more clearly stated in the case cited in the preceding quotation, *Morris R. DeWoskin*, in which the Tax Court held that even a capital loss is not allowable under such circumstances.

This view of the Tax Court, adopted by the Third Circuit, is directly in conflict with the opinions in *Becker* v. *Commissioner*, 277 F. 2d 146 (2d Cir. 1960) and in *MacRae* v. *Commissioner*, 294 F. 2d 56 (9th Cir. 1961), *cert. denied*, 368 U. S. 955 (1962).

The *Becker* case involved "variants of the plan for reducing income taxes by deductions for the alleged payment of interest on loans to finance the purchase of Government securities devised by M. Eli Livingstone of Boston." 277 F. 2d at 147. As in other cases involving such plans, the Second Circuit held that the interest payments were not deductible for federal income tax purposes. However, it went on to hold that the net out-of-pocket expenditures incurred by Becker in connection with the plan were deductible under section 117(g)(2) of the 1939 Code (now section 1234(a) of the 1954 Code) as short-term capital losses.

MacRae similarly involved "a plan devised by a firm of brokers and dealers in securities designed to create sizable 'interest' deductions for high-bracket taxpayers whose principal purpose in agreeing to the plan is to create tax deductions," 294 F. 2d at 58, and the Ninth Circuit similarly disallowed the claimed interest deductions. But the Ninth Circuit expressly agreed with the Second Circuit that the out-of-pocket losses of the taxpayer were deductible as short-term capital losses.

Thus, there is a direct conflict between the Third and the Second and Ninth Circuits as to whether any deduc-

tion is allowable in a case in which the taxpayer was seeking an economic gain by increasing his net after-tax income, a conflict which should be resolved by this Court.

It should be emphasized that by the preceding discussion, the petitioner is neither contending nor conceding that his out-of-pocket expenditures are deductible as short-term capital losses. The petitioner's position is, rather, that this Court should grant certiorari in order to determine whether a deduction of some sort is allowable, as held by the Second and Ninth Circuits, or whether no deduction at all is allowable, as held by the Third Circuit.

In this respect it should be pointed out that a short-term capital loss as well as an ordinary loss is subject to the same requirement, in the case of an individual, that it be incurred in a transaction entered into for profit in order to be deductible. Both section 117(g)(2) of the 1939 Code, under which the losses in *Becker* and *MacRae* were allowed, and successor section 1234(a) of the 1954 Code are definitional sections only. The deductions are granted by sections 23(e)(2) and 165(a) of the respective Codes,[1] both of which require (in the absence of a trade or business or a casualty) that the transaction in which the loss is incurred be entered into for profit. If certiorari is granted, the petitioner proposes to argue on the merits that the Second and Ninth Circuits are correct in deter-

1. Section 23(e)(2) of the 1939 Code, allowing the deduction of losses incurred in a transaction entered into for profit, is *limited* by section 23(g)(1) in the case of capital losses, to the extent provided in section 117. Section 117(g)(2), merely defines a loss from a failure to exercise an option as a capital loss.

Section 165(a) of the 1954 Code is limited by section 165(c), in the case of an individual, to losses incurred in a trade or business or in a transaction entered into for profit, or arising from a casualty. There is a further limitation of capital losses, by section 165(f), to the extent provided in sections 1211 and 1212. Section 1234(a) defines a loss from failure to exercise an option as a capital loss.

mining that deductions of out-of-pocket expenditures are allowable in this type of case, but that under the facts of this case, the deduction should be an ordinary loss (or expense) rather than a short-term capital loss.

2. The present case involves two important questions with respect to the federal income tax laws which have not been, but should be, settled by this Court.

a. Deduction of net out-of-pocket expenditures as expenses or losses.

Regardless of the conflict among Circuits over the deductibility of the out-of-pocket expenditures in a case such as the present one, the issue involved is one which merits this Court's review. This issue, of course, is whether an attempt to obtain an after-tax profit is a sufficient profit motive to support an expense or loss deduction for federal income tax purposes.

It is important, in considering the significance of this issue, to recognize that the petitioner's object was to obtain an after-tax profit, and not merely a tax deduction. Stripped to its essentials, the transaction entered into by the petitioner was a practical application of a principle which is still perfectly valid. Because of the large differential between the maximum capital gain rate of 25% and the maximum ordinary income rate of 91%, a taxpayer in the top brackets can afford to pay interest of up to $8.24 in order to carry an investment which would earn $1.00 in capital gain.

For example, in the present case, assuming that the transactions had been accorded the tax treatment expected by the petitioner, he would have been allowed aggregate interest deductions in 1952, 1953, and 1954 of $304,357.07. However, upon the sale of his three annuity contracts in

1954, he would have realized a taxable gain of $156,347.99, computed as follows:

Amount realized on sale:	
Total outstanding loans to which the annuity contracts were subject	$649,557.99
Cash consideration received for the annuity contracts	500.00
Total amount realized	$650,057.99
Less: Cost basis of annuity contracts (aggregate premiums paid)	493,710.00
Gain on sale	$156,347.99

While the gain of $156,347.99 would have been $148,009.08 less than the aggregate interest costs, the after-tax cost of the interest would have been only $75,939.80 (interest of $304,357.07 less $228,417.27,[2] the aggregate tax saving attributable to the interest deductions) and the after-tax gain on the sale would have been $117,261.00 (profit of $156,347.99 less $39,086.99, the 25% capital gains tax), thus showing a net profit of $41,321.20 to the petitioner. From these computations, it may be seen that the petitioner would have suffered an after-tax loss of $75,939.80 if there were no gain on the sale of the annuity contracts, even if his interest deductions had been allowed in full. It is self-evident that a deduction alone cannot be profitable (except, perhaps, as a short-run expedient), since a taxpayer cannot derive more than a 91% tax benefit from it.

2. This figure is the aggregate of the income tax deficiencies of $57,449.10, $78,845.50 and $92,122.67 in 1952, 1953 and 1954, respectively, attributable to the disallowance of the interest deductions.

Because of the repeated prepayments of interest and borrowings on the annuity contracts, there is a tendency to lose sight of the fact that capital gain on the annuity policies was an essential object of the petitioner; the interest deduction is immediate and particularly obvious, while the capital gain aspect is overlooked because it cannot be realized until the sale of the contracts. As it has turned out, both the interest deduction and capital gain elements of this transaction have not been allowed to the petitioner. However, it is grossly unfair, in determining whether the petitioner is entitled to a loss or expense deduction, to judge his profit motive in the light of the recent cases involving this type of transaction which have been adverse to the taxpayers. It must be remembered that when he entered into the transactions there was a series of Treasury Department letter rulings stating both that the interest was deductible and that gain on the sale of the annuity contracts would be treated as capital gain. Regardless of the legal effect of these rulings (which issue is discussed later), they certainly made it reasonable for the petitioner to expect a profit on the transaction in the manner indicated above.

That the petitioner's profit expectations were not unrealistic is further evidenced by the facts that the first case on the interest deduction issue was decided in favor of the taxpayer, *Bond* v. *United States*, 52 P-H A.F.T.R. 1262, 57-1 U.S.T.C. ¶9680 (S.D. Tex. 1957), *aff'd*, 258 F. 2d 577 (5th Cir. 1958), and that even in *Knetsch* v. *United States*, 364 U. S. 361 (1960), which held the interest not deductible, three justices dissented and would have ruled in favor of the taxpayer. The cases disallowing the interest deduction were all decided in 1959 or later years. On the issue whether gain from the sale of an insurance policy is capital gain, the first cases did not appear until

1958. *Percy W. Phillips*, 30 T.C. 866 (1958), *rev'd*, 275 F. 2d 33 (4th Cir. 1960); *Arnfeld* v. *United States*, 143 Ct. Cl. 277, 163 F. Supp. 865 (1958), *cert. denied*, 359 U. S. 943 (1959). And again the earlier of these cases, the Tax Court decision in *Phillips*, held that the gain *was* taxable as capital gain.

In discussing the allowability of the present petitioner's out-of-pocket expenditures as a loss deduction under sections 23(e)(2) and 165(c)(2), the Tax Court apparently recognized the existence of a profit motive but nevertheless denied the deduction because the profit sought was an after-tax profit. As previously mentioned, the Tax Court stated:

> "An economic gain for the petitioners would only result if the interest payments were allowed as a deduction and if the income accrued on the annuities would be realized as capital gain on a sale prior to maturity. We do not believe that a transaction may be considered as a transaction entered into for profit if the only economic gain derived therefrom results from a tax reduction." (92a)

This limited construction of the statutory phase "entered into for profit" is far reaching in its applicability, since it eliminates income tax considerations in determining profit motive. Unless there is expected a before-tax profit, the Tax Court would allow no loss deduction under the statutory provision in question. It is completely unrealistic, in view of the current tax structure which makes a dollar of income worth perhaps only ten cents while a dollar of tax saving is worth a full dollar, to speak of profit without giving full consideration to income taxes. In addition to the *Becker* and *MacRae* cases previously